No. 15025

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

HAROLD WENER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

MOLLY WENER,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petitions to Review Decisions of the Tax Court of the United States.

PETITIONERS' REPLY BRIEF.

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TOPICAL INDEX

TABLE OF AUTHORITIES CITED

Cases

Statutes

Textbook

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I.

The Arrowsmith Case Relied Upon by the Respondent Is Clearly Distinguishable and Is Not Applicable to the Facts of This Case.

The original sale by the Petitioners of their partnership interests in February, 1947 was a transaction constituting a capital loss. The troublesome problem presented to this Court is where at some subsequent date the taxpayer who sustained such a capital loss may have expenses or additional losses or income applicable to the earlier capital transaction. The question whether the later event is to be treated as a transaction completely separate from the earlier capital one or as a mere continuation of the original capital gain or loss has resulted in conflicting decisions in the courts of the United States.

The Supreme Court in settling a dispute as to the treatment of corporate debts paid by the stockholders after liquidation has solved one facet of this problem by its decision in the case of *Arrowsmith v. Commissioner,* 344 U. S. 6 (1952), relied upon by the Respondent. Unfortunately, that decision does not solve the question presented to this Court by the cases under review.

The *Arrowsmith* case, *supra,* holds that the losses sustained by shareholders from paying a judgment against a dissolved corporation, of which they were the liquidating-distributees, must be treated as capital losses. The reasoning of the Court was that the losses incurred were the result of the shareholders' transferee liability arising out of the liquidation, and since the liquidation was an "exchange" under Section 115(c) of the 1939 Internal Revenue Code, it followed that the loss should be a capital loss deducted under Section 23(g) of the 1939 Code. That case can be clearly distinguished from the facts of the cases under consideration in that it involved losses arising from the statutory liability of the recipient of a corporation's assets upon liquidation. The obligation of the distributee-shareholders to pay the judgment against the liquidated corporation was not based on any ordinary business transaction apart from the liquidation. The Court reasoned that if the judgment had been rendered against the corporation prior to liquidation it would have reduced the amount of corporate assets available for distribution upon liquidation to the shareholders with the resultant reduction in their capital gains from the transaction. It should be noted that the losses were the result of an absolute liability imposed upon the shareholders, flowing directly from the liquidation. In the cases under consideration the losses sustained by the Petitioners were not obligatory and were not the result of a legal liability arising out of the original capital transaction.

Because of the statutory derivative liability of the shareholders in the *Arrowsmith* case, *supra,* the capital transaction involved, namely, the exchange of stock for corporate assets, was not completed or finally determined until such time as the shareholders were relieved of their derivative liability by operation of law. In contrast, the sale by the Petitioners of their partnership interests was fully completed and closed on the date of the original transaction, and there was no future or contingent liability arising out of the original transaction to which they might be subject.

The *Arrowsmith* case can be further distinguished on the ground that the subsequent losses sustained by the shareholders were in effect, part of the consideration paid by them for the assets of the corporation, and hence a capital loss. (*Holdcraft Transportation Co.,* 153 F. 2d 323).

It is manifest that the *Arrowsmith* decision is limited to losses resulting from statutory liability arising out of the original transaction. It is further distinguishable in that it does not involve losses arising from the cancellation of indebtedness. The shareholders in the *Arrowsmith* case occupied the position of debtors who were legally compelled to pay a sum of money several years after the capital transaction which gave rise to their obligation to pay. On the other hand the Petitioners are creditors who voluntarily sustained losses by the cancellation of certain amounts of money which were owed to them. Certainly this distinction alone should be sufficient to hold that the *Arrowsmith* decision is inapplicable to the facts in this case. To extend the *Arrowsmith* rationale to all subsequent transactions that result in a gain or loss and that are related either directly or indirectly, to a prior capital transaction, would be unjustifiable and possibly result in creating more conflict or confusion in connection with the problem presented by this case than has heretofore existed. It must be kept in mind that many capital transactions are followed at some later date by a subsequent agreement involving the parties to the original transaction, the tax effect of which may come into question. A blanket application of the *Arrowsmith* decision to all subsequent transactions resulting in a gain or loss may prove to be undesirable to the taxing authorities under other circumstances. It should also be kept in mind that the *Arrowsmith* decision was reviewed by the Supreme Court to resolve a conflict between decisions of two circuits of the Court of Appeals on practically identical facts. For this reason it is submitted that the decision in the *Arrowsmith* case must be limited to the facts involved in both those cases and should not be extended to the different facts found in the case under consideration.

II.

The Settlement Transaction of August, 1947, Was Not a Renegotiation of the Executory Provisions of the Original Sale Contract and Its Nature Should Not Be Determined by Referring to the Original Sale Which Gave Rise to the Indebtedness.

The Respondent has taken the position that the settlement agreement of August, 1947 must be viewed as a renegotiation or modification of the original sale of February, 1947 between the Petitioners and their old partners. The Respondent is unable to cite any cases supporting this position but argues that merely because the balance of the purchase price was unpaid, therefore, any subsequent transactions between the parties to the sale must be construed as part of the original transaction. However, the Respondent fails to take into consideration the fact that the original transaction of February, 1947 was a completed transaction and he admits this fact in his brief. Further, for tax purposes it was a closed transaction and the Petitioners correctly reported the capital loss they sustained. Yet the Respondent would have the Court believe that simply because the balance of the purchase price was to be paid in installments, that any subsequent transactions between the parties must be construed as part of the original transaction which admittedly is completed and closed for all other purposes.

This reasoning of the Respondent completely overlooks the express provisions of the Mutual Release entered into between the Petitioners and their old partners in August of 1947. [R. 35-38.] That agreement makes absolutely no mention of the original capital transaction of February, 1947. Nothing in its terms indicates an intention of the parties to modify or adjust the sale. This fact is quite important in determining the validity of the Respondent's argument that the August transaction was a renegotiation of the sale of the partnership interests in February, 1947. In fact the Mutual Release clearly indicates by its express terms that it is no more than an actual cancellation of indebtedness.

The Respondent also contends that the effect of the acceptance of a lump cash payment by the Petitioners in August of 1947 in lieu of installment payments was to supersede the provisions of the original sale contract of February, 1947. This oversimplification of the effect of the August transaction overlooks the fact that the only act remaining to be done under the original contract was the payment of the balance of the purchase price. The relationship between the buyers and the Petitioners was that of debtor and creditor only. There was no security retained by the Petitioners. It is submitted that the acceptance by an unsecured creditor of a sum less than the amount owed to him in installment payments is not in itself a renegotiation or modification of the original transaction which gave rise to the indebtedness. The effect of such a transaction is the satisfaction of indebtedness by a lump sum payment and a cancellation of the unpaid balance. There is in fact no modification or revision of the original obligation to pay money by the acceptance of a lesser sum. The Respondent's contention that the settlement agreement of August was one of a series of acts in one entire transaction is completely without foundation or logic. Merely because a creditor, subsequent to the completed sale of a capital asset, chooses to accept a sum in cash less than the balance of the purchase price owing to him does not compel the conclusion that such a settlement is the final step in the prior sales transaction which is admittedly completed.

The Petitioners agree with the Respondent that the *Arrowsmith* case may well be an example of a series of transactions which must be viewed as a whole because of the statutory derivative liability imposed upon the taxpayers in that case. The Respondent points out in his brief that the payment of the judgment by the shareholders in the *Arrowsmith* case was one of the steps in the liquidation of the corporation, and was legally and logically related to the prior capital transaction. It is submitted that such is not the case at hand for the reason that the compromise of August, 1947, was not a legal obligation or liability arising out of the February sale. There was no such binding or direct relationship between the two transactions. The two situations are entirely different in nature and concept.

The case of *Sanders v. Commissioner,* 225 F. 2d 629 (C. A. 10th Cir.), cited by the Respondent is clearly inapplicable for the reason that it involved simply the compromise of a claim for construction work against the Government. The taxpayer settled his claim and received the agreed amount in compromise. He contended it should be treated as a capital gain but the Court properly held that any income he might have received under the original construction contract would be ordinary income, and there was no reason to treat the sum he received in compromise any differently. That case does not involve an original capital transaction, and a subsequent transaction arising out of the prior capital sale. If at some future date the Government had recovered part of the monies paid to the taxpayer, or if the taxpayer had been compelled to pay some unexpected or contingent liability arising out of the construction contract, then a situation similar to the case at hand would have arisen.

The Respondent cites three other cases in support of his contention that the nature of a later transaction is determined by referring to the original transaction. These cases are *Hirsch v. Commissioner,* 115 F. 2d 656 (C. A. 7th Cir.); *Helvering v. A. L. Killian Co.,* 128 F. 2d 433 (C. A. 8th Cir.); and *Pinkney Packing Co. v. Commissioner,* 42 B. T. A. 823. The *Hirsch* and *Killian* cases can be distinguished on the grounds that they involved the question of whether the cancellation of indebtedness was income to the purchaser, rather than a loss to the seller. These two cases are further distinguishable for the reason that the court relied heavily upon the depreciation in the value of the property during the depression years. Those cases stand for the proposition that where the value of the property sold depreciates to an amount less than the balance of the purchase price owed by the taxpayer, a reduction of the purchase price to the current value of the property does not result in taxable income to the purchaser-taxpayer.

The Respondent contends in his brief that this case is not the ordinary case of a satisfaction of indebtedness by the payment of a lesser sum but rather a complete adjustment in the terms of the original contract of sale. Yet the findings of the Tax Court do not indicate that there was any modification or change of the original sales contract other than the acceptance by the Petitioners of the sum of $35,000.00 in cash in complete satisfaction and discharge of $58,260.13 owed to them over a period of years. Contrary to the express finding of the Tax Court, and strangely not mentioned or considered at all in its opinion, is the express agreement in the Mutual Release of August, 1947, by the Petitioners to forgive and cancel the balance of the obligation owed to them, namely,

$23,260.13. It is difficult to understand how such an agreement can be construed as a matter of law as anything but an accord and satisfaction with the resulting cancellation of the unpaid portion of the purchase price. In that regard it is interesting to note that the Respondent causally dismisses the authorities cited by the Petitioners in their opening brief as being "inapposite to the factual situation at hand since here there is not a simple compromise or cancellation of indebtedness."

It apparently is the position of the Respondent that whenever there is a sale of a capital asset with the purchase price to be paid in installments over a period of time, that any compromise between the buyer and seller at a later date, where the seller accepts a lump sum payment in lieu of waiting for the installment payments, is not a cancellation of indebtedness but rather a complete renegotiation of the unexpected portions of the sales contract. Carrying this reasoning to its logical conclusion, there could never be any true cancellation of indebtedness arising out of the sale of a capital asset, for until the entire purchase price was paid the contract would still be executory. It is submitted that this position is not based on reason or logic; it represents a misleading attempt by the Respondent to label the settlement transaction of August 1947 as something different than what it really was, namely, a simple accord and satisfaction with a resulting cancellation of indebtedness.

III.

Even if the Tax Court Was Correct in Holding That the Petitioners Sustained Only Capital Losses, They Should Be Fully Deductible as a Business Loss.

The Petitioners have shown under Point III of their opening brief that the losses sustained by them as result of the August 1947 transaction are fully deductible as ordinary losses under Section 23(e) of the 1939 Internal Revenue Code.

It should be noted that in practically all of the cases cited by the Petitioners in their opening brief the Courts have held that the loss sustained by a creditor upon the compromise of indebtedness is an ordinary loss deductible in full even when the loss arose from the sale of a capital asset. (See I. T. 4018 (1950), 2 C. B. 20.)

It is the contention of the Petitioners that the losses sustained by them as a result of the August 1947 transaction were necessitated by and directly related to their new business in California. However, if the Court should decide that these losses are capital in nature then, in the alternative, the Petitioners urge the Court to allow such losses in full as having been incurred for a business purpose as stated in Petitioner's opening brief.

The Respondent contends that the *Hutcheson* and *Gannon* cases cited by the Petitioners in their opening brief do not support the Petitioner's position for the reason that those cases involved losses incurred in a trade or business. Those cases involved the surrender of a partnership interest by the taxpayers which was held by the Tax Court to be an ordinary loss even though the abandonment or surrender of a partnership interest is certainly not an activity associated with the conduct of any trade or business. It is submitted that if the forfeiture of such a capital asset can be deducted in full as an ordinary loss, then certainly the loss resulting from the cancellation of indebtedness by the Petitioners should be deductible in full, not only because the loss was directly related to a partnership interest in a manufacturing business, but also because the loss was necessitated by sound business reasons.

Conclusion.

In view of the arguments and reasoning set forth in this reply brief, the Petitioners sincerely urge the Court to hold that the *Arrowsmith* case is not applicable to the facts of this case, and that the losses sustained by the Petitioners were ordinary losses deductible in full.

Respectfully submitted,

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